

Department of Financial Institutions
For the Years Ended
June 30, 2001, and June 30, 2000

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STATE OF TENNESSEE
COMPTROLLER OF THE TREASURY

State Capitol
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John G. Morgan
Comptroller

August 22, 2002

The Honorable Don Sundquist, Governor
and

Members of the General Assembly
State Capitol
Nashville, Tennessee 37243

and

The Honorable Fred R. Lawson, Commissioner
Department of Financial Institutions
Fourth Floor, John Sevier Building
500 Charlotte Avenue
Nashville, Tennessee 37243

Ladies and Gentlemen:

Transmitted herewith is the financial and compliance audit of the Department of Financial Institutions for the years ended June 30, 2001, and June 30, 2000.

The review of management's controls and compliance with policies, procedures, laws, and regulations resulted in a finding which is detailed in the Objectives, Methodologies, and Conclusions section of this report.

Sincerely,

John G. Morgan
Comptroller of the Treasury

JGM/mb
02/044



**STATE OF TENNESSEE
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March 18, 2002

The Honorable John G. Morgan
Comptroller of the Treasury
State Capitol
Nashville, Tennessee 37243

Dear Mr. Morgan:

We have conducted a financial and compliance audit of selected programs and activities of the Department of Financial Institutions for the years ended June 30, 2001, and June 30, 2000.

We conducted our audit in accordance with government auditing standards generally accepted in the United States of America. These standards require that we obtain an understanding of management controls relevant to the audit and that we design the audit to provide reasonable assurance of the Department of Financial Institutions' compliance with the provisions of policies, procedures, laws, and regulations significant to the audit. Management of the Department of Financial Institutions is responsible for establishing and maintaining internal control and for complying with applicable laws and regulations.

Our audit disclosed a finding which is detailed in the Objectives, Methodologies, and Conclusions section of this report. The department's administration has responded to the audit finding; we have included the response following the finding. We will follow up the audit to examine the application of the procedures instituted because of the audit finding.

We have reported other less significant matters involving the department's internal controls and/or instances of noncompliance to the Department of Financial Institutions' management in a separate letter.

Sincerely,

A handwritten signature in black ink, reading "Arthur A. Hayes, Jr." in a cursive script.

Arthur A. Hayes, Jr., CPA,
Director

AAH/mb

State of Tennessee

Audit Highlights

Comptroller of the Treasury

Division of State Audit

Financial and Compliance Audit
Department of Financial Institutions
For the Years Ended June 30, 2001, and June 30, 2000

AUDIT SCOPE

We have audited the Department of Financial Institutions for the period July 1, 1999, through June 30, 2001. Our audit scope included a review of management's controls and compliance with policies, procedures, laws, and regulations in the areas of revenue, expenditures, equipment, payroll and personnel, external examinations, and compliance with the Financial Integrity Act. The audit was conducted in accordance with government auditing standards generally accepted in the United States of America.

AUDIT FINDING

Billing Practices and Examination Records Need Improvement

The department's examination billing practices are not consistent, and there is inconsistent information in the department's examination records (page 7).

"Audit Highlights" is a summary of the audit report. To obtain the complete audit report, which contains all findings, recommendations, and management comments, please contact

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Audit Report
Department of Financial Institutions
For the Years Ended June 30, 2001, and June 30, 2000

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Department of Financial Institutions

For the Years Ended June 30, 2001, and June 30, 2000

INTRODUCTION

POST-AUDIT AUTHORITY

This is the report on the financial and compliance audit of the Department of Financial Institutions. The audit was conducted pursuant to Section 4-3-304, *Tennessee Code Annotated*, which authorizes the Department of Audit to “perform currently a post-audit of all accounts and other financial records of the state government, and of any department, institution, office, or agency thereof in accordance with generally accepted auditing standards and in accordance with such procedures as may be established by the comptroller.”

Section 8-4-109, *Tennessee Code Annotated*, authorizes the Comptroller of the Treasury to audit any books and records of any governmental entity that handles public funds when the Comptroller considers an audit to be necessary or appropriate.

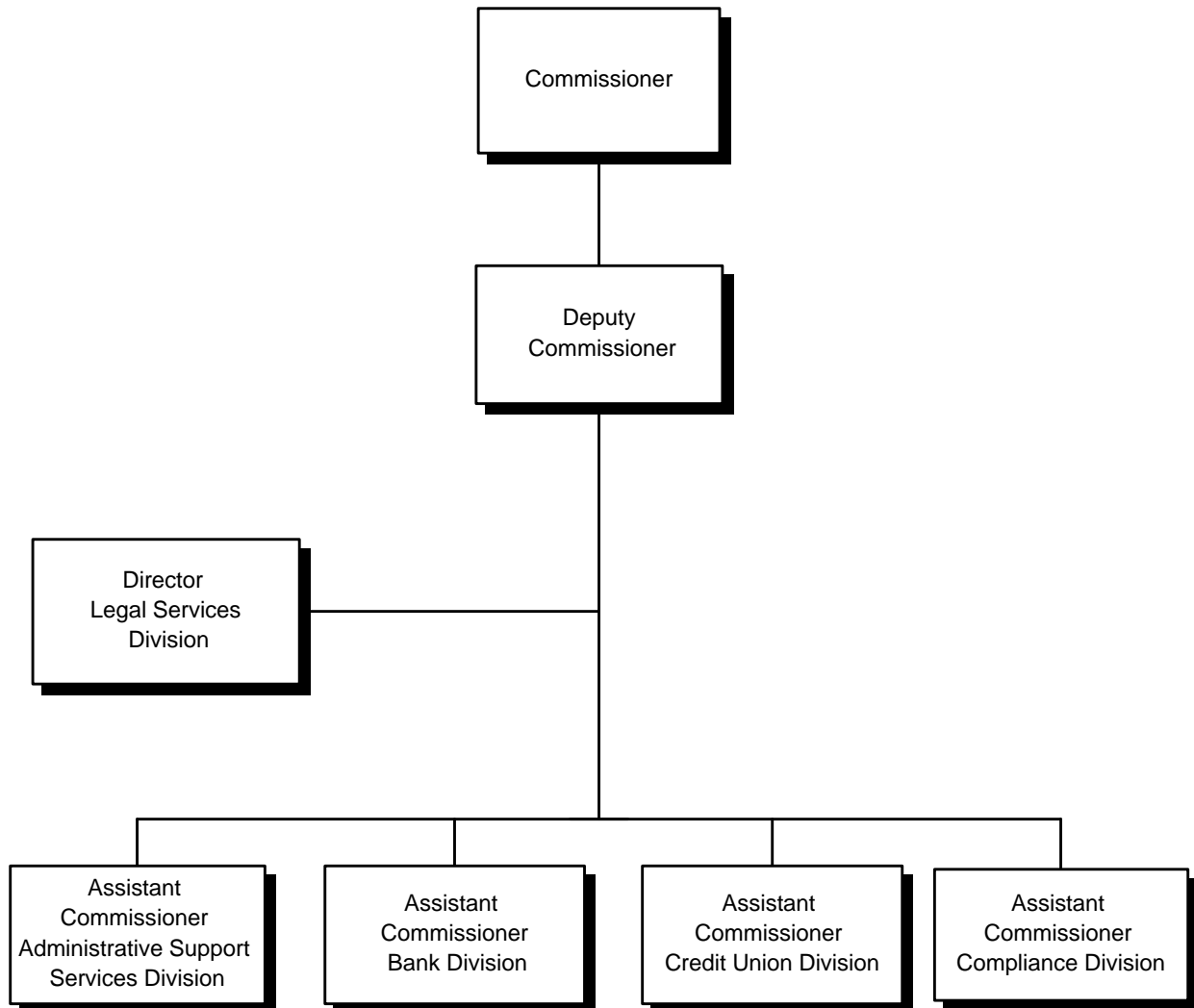
BACKGROUND

The primary mission of the Department of Financial Institutions is to provide the citizens of Tennessee with a sound system of state-chartered financial institutions. The Bank Division is responsible for the regulation and supervision of state-chartered financial institutions such as state-chartered banks, savings banks, savings and loan associations, credit card banks (banks which only engage in credit card operations), and business and industrial development corporations (BIDCOs). The Credit Union Division is responsible for the regulation and supervision of state-chartered credit unions. The Compliance Division is responsible for regulatory oversight activities such as licensing, examination, and complaint resolution for industrial loan and thrift companies; insurance premium finance companies; home mortgage servicing, lending, and brokering; money transmitters (money order issuers); and title pledge lending. On March 1, 1998, the Department of Financial Institutions became responsible for examining check cashing and deferred presentment companies.

The Department of Financial Institutions attempts to encourage the development of depository financial institutions while restricting their activities to the extent necessary to safeguard the interests of depositors. The department also works to ensure that both depository and nondepository financial institutions comply with governing laws and regulations.

An organization chart of the department is on the following page.

DEPARTMENT OF FINANCIAL INSTITUTIONS ORGANIZATION CHART



AUDIT SCOPE

We have audited the Department of Financial Institutions for the period July 1, 1999, through June 30, 2001. Our audit scope included a review of management's controls and compliance with policies, procedures, laws, and regulations in the areas of revenue, expenditures, equipment, payroll and personnel, external examinations, and compliance with the Financial Integrity Act. The audit was conducted in accordance with government auditing standards generally accepted in the United States of America.

PRIOR AUDIT FINDINGS

Section 8-4-109, *Tennessee Code Annotated*, requires that each state department, agency, or institution report to the Comptroller of the Treasury the action taken to implement the recommendations in the prior audit report. The Department of Financial Institutions filed its report with the Department of Audit on February 28, 2001. A follow-up of all prior audit findings was conducted as part of the current audit.

RESOLVED AUDIT FINDINGS

The current audit disclosed that the Department of Financial Institutions has corrected previous audit findings concerning bank examination compliance and conflict of interest compliance.

OBJECTIVES, METHODOLOGIES, AND CONCLUSIONS

REVENUE

Our objectives in reviewing revenue transactions were to determine whether

- revenue transactions appear accurate and valid,
- revenues collected in connection with licensing or chartering of financial institutions are supported by documentation of the granting or renewing of a license or charter,

- cash collected during the fiscal year was deposited timely and accounted for in the appropriate fiscal year, and
- fees had been billed or charged and recorded at the correct amount.

We discussed collection and receipt controls and procedures with key management personnel to gain an understanding of the department's procedures over these areas. We reviewed supporting documentation and tested a nonstatistical sample of transactions that were deposited during the audit period by tracing deposits through the receipting process to determine whether controls were adequate and records were complete.

Based on our interviews and reviews of supporting documentation, we determined that revenues collected in connection with licensing or chartering of financial institutions are supported properly. We also determined that cash collected during the fiscal year was deposited timely and accounted for in the appropriate fiscal year. Based on our testwork, we determined that revenue transactions appear accurate and valid and that fees had been billed or charged and recorded at the correct amount. Although we had no findings related to revenue, a minor weakness was reported to management in a separate letter.

EXPENDITURES

Our objectives in reviewing expenditure transactions were to determine whether

- expenditures were for goods and services authorized and the goods and services were received;
- expenditures for goods and services were properly recorded to account, budget category, period, and amount;
- payments were made in a timely manner;
- records were reconciled with Department of Finance and Administration reports;
- payments for travel were made in accordance with the *Comprehensive Travel Regulations*; and
- funds encumbered were liquidated for the same purpose as the original encumbrance.

We discussed purchasing, receiving, disbursement, contract, and reconciliation controls and procedures with key management personnel to gain an understanding of the department's procedures over these areas. We reviewed supporting documentation and tested a nonstatistical sample of transactions to determine whether transactions were adequately supported and approved, invoices were mathematically correct, duplicate payment was precluded, discounts were taken, transactions were charged to the proper object code, sales tax was not paid, proper bidding procedures were followed, travel regulations were followed, single-source purchases were properly approved, journal voucher transfers were proper, and invoices were not split.

Based on our interviews and reviews of supporting documentation, we determined that expenditures were for goods and services authorized; the goods and services were received and properly recorded to account, budget category, period, and amount; and payments for travel were made in accordance with the *Comprehensive Travel Regulations*. Based on our testwork, payments were made in a timely manner, records were reconciled with Department of Finance and Administration reports, and funds encumbered were liquidated for the same purpose as the original encumbrance.

EQUIPMENT

Our objectives in reviewing equipment were to determine whether equipment

- is properly safeguarded,
- is properly recorded on the property listing, and
- can be located.

We discussed controls and procedures over equipment with key management personnel to gain an understanding of the department's procedures over these areas. We reviewed supporting documentation and tested a nonstatistical sample of sensitive and high-price items, and a nonstatistical sample of all equipment to determine whether they were correctly added to the department's property listing with the correct price, serial numbers, tag numbers, descriptions, and location of equipment. We tested the nonstatistical samples to determine agreement with the Property of the State of Tennessee (POST) listing. We traced a nonstatistical sample of equipment located in the offices to the property listing to ensure that the items were properly recorded on the property listing.

Based on our interviews and reviews of supporting documentation, we determined that property and equipment were properly safeguarded. Based on our testwork, we determined that equipment purchases were properly added to the property listing, and the department's property listing represented a complete and valid listing of the assets physically on hand. Although we had no findings related to equipment, minor weaknesses were reported to management in a separate letter.

PAYROLL AND PERSONNEL

Our objectives in reviewing payroll and personnel were to determine whether

- payroll disbursements were made only for work authorized and performed;
- payroll is recorded correctly, distributed properly, and computed using rates in accordance with contracts, laws, and regulations;
- employees are qualified for their positions;

- performance evaluations are completed timely; and
- retirees of the Tennessee Consolidated Retirement System used as temporary employees are employed in compliance with *Tennessee Code Annotated*.

We discussed controls and procedures over payroll and personnel with key management personnel to gain an understanding of the department's procedures over the areas. We tested a nonstatistical sample of payroll transactions to ensure they were adequately supported and approved, mathematically correct, and charged to the proper cost center. In addition, we confirmed employment with the employee.

Based on our interviews and reviews of supporting documentation, we determined that employees were qualified for their positions, performance evaluations are completed timely, and retirees of the Tennessee Consolidated Retirement System used as temporary employees are employed in compliance with *Tennessee Code Annotated*. Based on our testwork, we determined that payroll was recorded correctly, distributed properly, and computed using rates in accordance with contracts, laws, and regulations, and payroll disbursements were made only for work that was authorized and performed. Although we had no findings related to payroll and personnel, a minor weakness was reported to management in a separate letter.

EXTERNAL EXAMINATIONS

Our objectives in reviewing external examinations of institutions regulated by the department were to determine whether

- the agency has written policies and procedures in compliance with laws, regulations, and standards;
- the agency is properly planning, documenting, reviewing, and reporting its examination assignments;
- the agency's examiners are properly qualified for their positions; and
- the agency's examiners are properly supervised.

We discussed controls and procedures over external examinations with key management personnel to gain an understanding of the department's procedures over these areas. We tested a nonstatistical sample of examinations of banks, trust companies, credit unions, industrial loan and thrift companies, and premium finance companies to determine whether the department has performed the examinations in accordance with the state's rules and regulations. We tested the nonstatistical sample of bank examiners for proper supervision. We also tested a nonstatistical sample of examiners to verify their qualifications.

The audit revealed that the department has no written policy for all billing practices, and its practices for compliance examinations are not consistent. In addition, the department's information regarding examination results is not consistent as noted in the finding.

Based on our interviews and reviews of supporting documentation, we determined that the agency has written policies and procedures in compliance with laws, regulations, and standards, and the agency's examiners are properly qualified for their positions. Based on our testwork, we determined that the agency is properly planning, documenting, reviewing, and reporting its examination assignments, and the agency's examiners are properly supervised.

Billing practices and examination records need improvement

Finding

During the review of the files of the department's external examinations, it was noted that the Compliance Division had billed one deferred presentment business for an examination that was not conducted. According to Section 45-17-111, *Tennessee Code Annotated (TCA)*, the Commissioner has the authority to examine a licensee for compliance with *TCA* title 45 and charge \$200 for any examination conducted.

As part of these examinations, the compliance examiners are to complete a checklist to ensure the business's compliance with *TCA*. The files for one of the deferred presentment businesses contained evidence that a compliance examiner traveled to the business and found it closed during its posted business hours. The examiner waited an hour for the business to open. According to conversations with Compliance Division management, the examiner requested and received approval to bill the business for an examination although the examination checklist was not complete and the examiner never entered the premises. Upon receiving approval, the examiner left an invoice at the business and entered a comment in the violation section of the examination checklist. The comment stated that the business was not open during the scheduled business hours and the examination needed to be rescheduled at a later date. In addition, the comment stated that it was important for the business to have an examination due to the extremely high number of violations noted in the previous examination.

Apparently, as a result of the department's billing and collection of the examination fee, the division's database listed this examination as complete, even though no examination was completed. The examiners submit a spreadsheet weekly to document the businesses that were visited and if they had a complete exam or not. The auditor reviewed the examiner's spreadsheet for the week the examination occurred, and there was no documentation of a visit or examination on the examiner's weekly spreadsheet for that deferred presentment business.

Although this may have been an isolated occurrence, it reveals several problems with the billing process. The division has no consistent billing practices concerning the examinations of deferred presentment business. According to management, similar occurrences might not result in billings to the businesses. Furthermore, there is inconsistent information in the various departmental records. The incomplete checklist in the file indicates that an examination needed to be rescheduled, the department's database indicates that an examination was completed, and the examiner's spreadsheet does not indicate that the business was visited or examined.

Management contends that this particular billing was not for an examination but for the recovery of costs associated with the examiner's time. Management believes that this is permitted by Section 45-1-118 (f)(1), *Tennessee Code Annotated*, which states, "The department may recover the costs of examination and supervision of a financial institution, subsidiary, or service corporation for supervision or examination which are in addition to the costs associated with the level of supervision ordinarily required." However, management acknowledges that applying the practice of billing for cost recovery of idle examiners' time rather than performance of examinations would probably result in rural businesses being more susceptible to billing when examinations were not performed. Such a billing practice neither seems fair nor appropriate.

Recommendation

The Compliance Division of the Department of Financial Institutions should establish a clear written policy for assessing and billing examination services beyond the normal course of examinations and apply them consistently to all businesses under its authority. If the department adopts a uniform policy for billing incomplete or attempted examinations, the department's database should be modified to allow for billing of this type of service without showing the examination as completed so that the database will reflect compliance with the stated 12-month examination cycle. Furthermore, all departmental records should contain consistent and accurate information relative to examination matters and results.

Management's Comment

We concur. We acknowledge that prior to the audit, the Division did not maintain a written policy as to the billing of an examiner's time in those rare instances in which a licensee fails to be open for business during its posted business hours. As a result of the audit, the Compliance Division has now adopted a written policy to cover these rare instances. We have also modified our database to distinguish between complete examinations and those where a company is billed when they fail to be open during their regular business hours.

FINANCIAL INTEGRITY ACT

Section 9-18-104, *Tennessee Code Annotated*, requires the head of each executive agency to submit a letter acknowledging responsibility for maintaining the internal control system of the agency to the Commissioner of Finance and Administration and the Comptroller of the Treasury by June 30 each year.

Our objective was to determine whether the department's June 30, 2001, and June 30, 2000, responsibility letters were filed in compliance with Section 9-18-104, *Tennessee Code Annotated*.

We reviewed the June 30, 2001, and June 30, 2000, responsibility letters submitted to the Comptroller of the Treasury and to the Department of Finance and Administration to determine adherence to the submission deadline. We determined that the Financial Integrity Act responsibility letters were submitted on time.

APPENDIX

ALLOTMENT CODE

The Department of Financial Institutions' allotment code is 336.00.